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Oliphant, Jas. H., & Co.

The problem of depreciated investment...

New York

[c1920]

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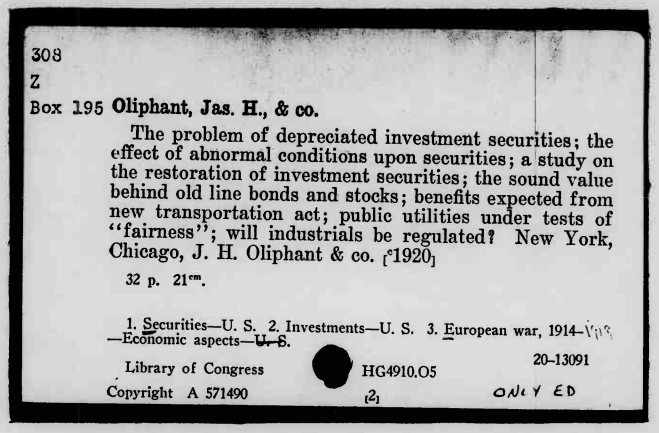

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Box 195 **Oliphant, Jas. H., & co.**

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THE DECLARED POLICY to which from its earliest history our house has rigidly adhered is that we do not sell securities to our clients. We buy and sell securities for our clients on a strictly commission basis, and do not, as dealers, trade with them. Charges made by us are the standard commission rates.

We give close attention to the study of investments and believe that we are capable of giving sound advice regarding the relative merits of securities.

We make no charge to our clients for information or suggestions furnished them. Our opinions are not prejudiced by reason of any interest involved due to ownership of securities.

Jas. H. Oliphant & Co.

A Third Printing

In November 1920, in response no less to the gratifying commendation accorded it than to our belief that the predictions made therein had only in part seen their realization, we issued a second printing of our brochure, "The Problem of Depreciated Investment Securities," originally published in June of that year.

As one looks back over the history of investment securities, one is impressed by the influence of fundamental principles, a study of which is hazarded in this pamphlet. The inexorableness of their working is but made clearer by the action of investment securities during recent epoch-marking years.

During the period of the world war great activity characterized the dealings in securities listed on the stock exchanges. The activity centered in the industrial shares—with millions of shares dealt in at rising prices we witnessed what appeared to be a tremendous "bull" market. Little attention was given to the downward course of market prices in those groups of securities—bonds of every description and the stocks of railroad and public utility companies—which together consti-

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tute by a large preponderance the structure of publicly owned securities.

The industrials came into prominence and public favor, benefited by the conditions which sprung from the influences of a world war. Here were the nations of the world, using the taxing power of the governments of the world to secure all the capital and credit in the world necessary to buy everything in the world at more or less the asked prices in order to win a world war. The producer, merchant, manufacturer, distributor, the laboring man, all had something to sell in a market which favored altogether the sellers—in many instances it seemed that the sky only was the limit.

Under such conditions, with the purchasing value of the dollar at one time below forty cents, there is easily apparent the plight not only of those individuals who existed on a fixed or limited income, but also of the railroads and public utility companies which together are the largest buyers of materials, supplies and labor. In 1916 the operating expenses and taxes of the Class I railroads in the United States were in round figures $2,500,000,000, in 1920 $6,000,000,000, an increase of about 3½ billions, whereas at the highest level of operating revenues during the period 1916 to 1925 inclusive, no year showed an increase over 1916 in revenues by an amount exceeding 2½ billions of dollars.

In the past five calendar years the bare operating expenses of the Pennsylvania R.R.—expenses such as in the case of an individual would be required for food, clothing and shelter—averaged $539,000,000 annually (highest $590,500,000, lowest $517,400,000). Such expenditures included nothing for taxes (in 1925, $31,700,000), interest, rentals, guarantees or dividends. A saving of one percent in such vast expenses means over $5,000,000 increase in net; 5½% saving means an increase in net of almost $30,000,000, equivalent to the amount now paid annually in dividends on Pennsylvania R.R. capital stock. So with the dollar growing in purchasing power and with increase in efficiency, it is not surprising that in 1925, with about $27,000,000 increase in operating revenues and despite an increase of over $14,000,000 in maintenance expenditures, the Pennsylvania R.R. reported over $21,000,000 increase in net operating income compared with 1924.

Such influences have been and are today at work in respect of all railroads and public utility companies. Similarly the bond coupon has been growing in purchasing value and by the same token the bond itself in market value.

Without attempting to cite extreme high or low prices (reached neither in 1914 nor 1920 respectively) the following table shows the record typical

of the trend of market values of bonds generally and the stocks of railroad and public utility companies. March, 1914 was several months prior to the beginning of the World War, March, 1920 was near the beginning of the deflation period, and market prices of these months are compared with present day prices, an even six years separating the periods—1914, 1920 and 1926.

	*Rate %	Highest	Mar. 20, 1914	Mar. 20, 1920	Change, 1914–1920	Mar. 20, 1926	Ch'ge 1920–1926
N. Y. City Corp. Stock, 1963	4½	109 (1916)	106⅛	96¼	− 9⅞	101⅝	+ 8¼
Atch. Top. & S. F. Ry., Genl., 1995	4	105½ (1905)	95⅛	77½	−17⅝	90½	+13
N.Y. Gas & El. L. H. & P. Co. 1949	4	92 (1906)	84½	64	−20½	90¾	+26¼
Indiana Steel Co. 1st, 1952	5	105 (1916)	101⅜	92	− 9⅜	104	+12
Pennsylvania R.R. Stock	6	170⅞ (1902)	112⅞	86⅝	−26	102⅝	+16
Illinois Central R.R. Stock	7	184½ (1906)	110	91	−19	116	+25
Peoples Gas Lt. & Coke Co. Stock	8	130 (1926)	124	39	−85	118¾	+79¾
Pullman Co. Stock	8	270 (1906	152¾	121½	−31¼	152	+30½

**Peoples Gas Light & Coke Co. paid dividends of 8% in 1914; no dividends were paid in the years 1918-22 inclusive; the present rate is 8%. Pennsylvania R. R. reduced the dividend to 4% from May, 1921 to November, 1922. Illinois Central reduced the dividend to 6% in 1915, increased it to 6% in 1916, and restored the 7% rate in 1917.*

Appreciation has replaced depreciation in investment securities with the restoration of freedom to the working of world-wide peace-time factors since 1920-21. A good part of the retreat of values before the war influence of capital destruction has been retraced.

How about the future?

Bond prices have substantially recovered the ground lost between 1914 and 1920. The future course will be determined by the cost of capital and other influences such as the purchasing value

of the dollar which promises further increase over a period of years to the betterment of the market position of fixed obligations.

As to stocks of public utilities, the better of these doubtless have a bright future as investments, particularly the stocks which represent substantial equities in companies the financial structures of which have not been "pyramided" through the issuance of an undue proportion of bonds and other non-voting securities. Admittedly this group as a whole has had a phenomenal price enhancement during recent months, such advance having been marked by great speculative activity, accompanied in many instances by split-up of shares, "pyramiding," and deals having to do with consolidation and extension developments.

Now coming to the railroad shares, many of these are, relatively, soundly priced. Similar influences to those which have so greatly benefited the public utility companies are steadily and irresistibly at work to restore the railroads, giving every promise that under reasonably favorable conditions railroad stocks will reach a much better price level. It will be recalled that railroad stocks outstanding today are not greatly increased over the amounts outstanding five, ten and fifteen years ago. Many companies have outstanding the same amount of stock as existed twenty-five years ago. Taxes may

well be expected to become less (they were $363,000,000 for Class I railroads in 1925 contrasting with roughly $330,000,000 dividends paid in that year and with $163,000,000 taxes in 1916); public relations are greatly improved, recognition is now as never before given to the principle that the owners are justly entitled to a fair return from capital devoted to public service. Witness in the field of public utilities the court decisions and the changed attitude of the regulatory commissions.

With peace-time conditions being established, the menace of inflation being dissipated and with deflationary tendencies continuing, with all that these influences promise toward the restoration of credit (the "margin of safety") and toward the recovering of dividend-earning and dividend-paying capacity, we cannot believe otherwise than that railroad stocks, irrespective of normally recurring setbacks, are headed for much higher market prices than those presently ruling. They will return to something like their earlier prominence and favor among investors.

Take alone the stocks which represent the equities in seven systems—Pennsylvania R.R., Baltimore & Ohio R.R., Southern Pacific Co., Illinois Central R.R., Northern Pacific Ry., Great Northern Ry., and Chicago & North Western Ry. These amount at par value to about $1,800,000,000; the market

value is today about $1,600,000,000 notwithstanding the fact that during the past twenty-five years almost exactly $1,000,000,000 of the total stock was issued against over $1,000,000,000 cash paid in and the further fact that during this period about $1,100,000,000 was turned into the treasuries of these companies from the net income remaining after all dividend payments—these funds together so realized have been appropriated for properties which could not be acquired today except at a cost some hundreds of millions over and above the original outlay.

The pamphlet here reprinted narrates the causes which were instrumental in depreciating investment securities, bonds and stocks, and by the same token accounts for the progress of their restoration. As our edition of November, 1920 has been exhausted, we are pleased to issue this Third Printing, believing that the principles therein discussed are of permanent character and influence.

Not amiss we may add that the concepts set forth, constituting a declaration of faith by us, have been and will continue to be elaborated in various ways by presentations in our monthly "Studies in Securities" touching upon the different investment groupings.

JAS. H. OLIPHANT & CO.

New York
April, Nineteen Twenty Six

The Problem of Depreciated Investment Securities

The Effect of Abnormal Conditions Upon Securities
A Study on the Restoration of Investment Securities
The Sound Value Behind Old Line Bonds and Stocks
Benefits Expected From New Transportation Act
Public Utilities Under Tests of "Fairness"
Will Industrials Be Regulated?

Jas. H. Oliphant & Co.

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NEW YORK
61 Broadway

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The Rookery

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We do not guarantee the statements and figures presented, but they are taken from sources which we believe to be accurate.

JAS. H. OLIPHANT & CO.

The Problem of Depreciated Investment Securities

War and Security Prices

PRIOR to the World War, stocks and bonds listed on the Exchanges were wont to be strong or weak according as prevailing conditions of prosperity and of the economic and financial situation influenced more or less the entire group of securities. With the advent of the war the prices of different classes of corporation securities took opposite courses in the market and the prices of those securities which represent by far the greater market value have fallen more or less steadily until their prices are today about the lowest recorded in years. For every one-thousand dollars invested in the securities of companies which have benefited, several thousands of dollars are invested in securities which have paid tribute to the extraordinary conditions which emerged from the war.

Evidences of prosperity have been found on all sides. Business men, producers, manufacturers, merchants and banking institutions—all alike have realized large profits; whereas, labor has enjoyed the fullest measure of employment and reward. We have been living in a sellers' market where those who have had leather, woolen, steel, food products, et cetera, to sell have indeed sold "gloriously."

Accordingly, certain kinds of stocks listed on the Exchanges, and unlisted, have been advancing in price over recent years and many companies have become rich. All the securities the prices of which have advanced, taken together, represent, however, only a small part of the entire securities structure. This is easily understood when comparison is made between the aggregate volume of the various issues of stocks and bonds the prices of which have fallen during the past six years and that of issues the prices of which have advanced.

Taken at their present prices, averaging about the lowest in many years, thirty listed common stocks of railroad and public utility companies, we find their market value is larger than that of one hundred listed common stocks of prominent "industrials."

In recent years, as is well known, transactions in the war prosperity shares have exceeded in volume by overwhelming odds the transactions in the shares of companies which have been injured by conditions sprung from the war. So far as concerns publicly owned corporation securities and the relative effects upon them produced by war conditions, the following representative comparison tells its own story. Stocks are presented in the comparison where the amounts outstanding have been changed relatively but little during the past six years. In respect of the stocks listed in Table I, approximately $174,000,000 stock (now representing at market value about $146,000,000) has been issued since 1914, against about $184,000,000 original cash received by the issuing companies. The entire increase in stocks listed in Table II was only about $5,000,000.

TABLE I.—RAILROAD AND PUBLIC UTILITY COMPANIES
Par value $100 per share excepting Penna. R. R.
(Dividend rates corrected to June 15, 1920)

Stocks	Div. Rate	Approximate Amount Outstanding	Price June 12, 1914	Price June 12, 1920	*See "Note" Below* Price (Adjusted) March 20, 1926
Amer. Tel. & Tel. Co.	*8%	$442,115,300	123	95	*145*
Atch., Top. & Santa Fe Com.	*6	222,949,000	99	79	*125*
Chic. & N. Western Ry. Com.	†5	145,165,810	132	70	*68*
Consolidated Gas of N. Y.	*7	100,384,500	129	80	*135*
Great Northern Ry. Pfd.	*7	249,477,800	125	66	*71*
Illinois Central R. R.	‡7	109,296,000	114	82	*116*
N. Y. Central R. R.	*5	247,889,900	93	67	*123*
Pennsylvania R. R. ($50 par)	*6	499,296,400	112%	77%	*102%*
Pullman Co.	*8	120,000,000	155	110	*152*
Union Pacific R. R. Com.	§10	222,291,600	§126	113	*146*
		$2,358,866,310			

*Dividend rate unchanged since 1914.
†Dividend rate reduced in June, 1920, from 7%.
‡Dividend rate increased 2% per annum over rate paid in 1914.
§Dividend rate reduced in 1914 to 8%; later restored to 10%. The price given here is adjusted to conform with price after distribution made in 1914.

TABLE II.—INDUSTRIAL COMPANIES
Par value $100 per share

Stocks	Dividend Rate 1914	*Avg. Rate 5 Years to Jan. '20	Approximate Amount Outstanding	Price June 12, 1914	Price June 12, 1920	*See "Note" Below* Price (Adjusted) March 20, 1926
Amer. Car & Fdy. Co. Com.	2%	5.80%	$30,000,000	51	143	*197*
Amer. Woolen Co. Com.	0	6.85	20,000,000	16	101	*33*
Baldwin Loco. Works Com.	2	.20	20,000,000	46	119	*106*
Central Leather Co. Com.	2	7.40	39,689,100	37	68	*13*
Corn Products Co. Com.	0	0	49,784,000	9	94	*190*
International Paper Co. Com.	0	0	19,958,900	9	77	*50*
Pressed Steel Car Co. Com.	3	5.00	12,500,000	44	100	*58*
Republic Iron & Steel Co. Com.	0	3.60	30,000,000	24	94	*54*
‡U. S. Food Products Corp.	0	4.10	30,944,800	17	66	*0*
U. S. Steel Corporation Com.	5	9.80	508,302,500	62	95	*123*
			$761,179,300			

*Includes regular and extra payments.
‡Formerly Distillers Securities Corporation.
Note: Dividend rates shown in Table I have been changed by increases to 9% on American Telephone, 7% on Atchison, 10% equivalent on Consolidated Gas, and 7% on N. Y. Central, and by decreases to 4% on Chicago & North Western and 5% on Great Northern. Of stocks in Table II American Car & Foundry is receiving 12% equivalent, Baldwin 7%, Corn Products 10% equivalent, and U. S. Steel 7%, including 2% extra—others are receiving nothing. (Corrected to April, 1926.)—J. H. O. & Co.

TABLE III.

Approximate totals are given in this table	Ten Stocks of "Buying" Companies Table I Above	Ten Stocks of "Selling" Companies Table II Above
Stock Outstanding at par	$2,358,866,310	$761,179,300
Market Value at June 12, 1914*	$2,758,000,000	$384,000,000
Market Value at June 12, 1920	1,966,000,000	720,000,000
Change in Market Value	Loss 792,000,000 (28%)	Gain 336,000,000 (87%)
Recorded transactions on N. Y. Stock Exchange:		
1918	3,922,094 shrs.	46,812,163 shrs.
1919	6,069,123 shrs.	62,844,065 shrs.
Total	9,991,217 shrs. (*42% of total stock*)	109,656,228 shrs. (*1440% of total stock*)

*This total includes amount of cash originally paid in, against which additional stock has been issued since 1914.

Above table brought up to date of preparation of this Third Printing, shows interesting confirmative changes, namely: recorded transactions in 1925 were 46% of total stock for "Buying" Companies and 283% for "Selling" Companies, with a 52% increase in market value of the "Buying" Companies' stocks since June 12, 1920 to date compared with a 14% increase in the same period for the "Selling" Companies' stocks.—J. H. O. & Co.

Taking into account the shrinkage in price of the comparatively large amount of bonds and preferred stocks of the railroads and public utilities, herein called the "buying" companies, we come to realize that the above comparison is free from any suspicion of exaggeration.

From a scrutiny of the facts presented above it is not difficult to perceive that industrial securities have become very conspicuous in the world of finance!

There are outstanding approximately 10,000,000 shares of stock of the Pennsylvania R. R. Each one "point" or two per cent. of par value change in market price rep-

resents a gain or shrinkage, as the case may be, of $10,000,000 in the value of the stock, an amount equivalent to the entire market value of the stock of the New York Air Brake Company and about one-half of the entire market value of the common stock of the Baldwin Locomotive Works.

Erstwhile Controlling Fundamentals

In normal times, general prosperity is measurably promoted by the investment of accumulated capital in the development not only of producing and manufacturing but also of transportation and public service enterprises. So far as concerns the average investor in securities, the last named enterprises have absorbed over the years by all odds the greater part of his accumulated savings. As the situation presents itself today, we venture to say that of all corporate securities, bonds and stocks alike, listed on the prominent Exchanges and unlisted securities dealt in "over the counter," seventy-five per cent.* is represented by stocks and bonds of railroad and public service companies. For years prior to the war these securities were generally and in many instances almost exclusively recommended by bankers and investment houses.

They were universally recommended and eagerly absorbed because they appeared to possess the underlying fundamental qualities, the eternal verities of value inherent in sound investments. These as applied to railroad bonds and stocks, comprised for instance the following characteristics:—

**This percentage is lowered somewhat by innovation since 1920 of public ownership in numerous industrial corporations previously privately owned.—J. H. O. & Co., 1926.*

(a) Strong and in many instances impregnable strategic position.

(b) Monopolistic nature of the business.

(c) The permanent nature of the business.

(d) The necessity feature of the product—transportation; in the final analysis the prosperity of railroads is indissolubly bound up with the prosperity of the country.

(e) Large cash investment in and original cost of the plant.

(f) Enormous reproduction value.

(g) The relatively consistent earnings' record shown in the business.

(h) The relatively excellent credit enjoyed over a long period of years.

(i) The large margin of safety shown in earnings over fixed charges for the protection of the financial integrity of the companies.

(j) The favorable record of uninterrupted dividends paid over a series of years.

(k) The business conducted on a cash upon delivery basis; no large inventories to be marked up, and none to be marked down.

These elements of value have for years been regarded as essentially governing desiderata of sound investment securities. Their recognition is expressed in the more rigorous laws controlling the investment of trust funds and the funds of Savings Banks and Insurance Companies.

The so-to-speak old-line investment securities have been the reservoirs into which has been deposited in one manner or another a large part of the people's savings. These savings flowing through the purchase of their bonds and stocks into the treasuries of the railroad

and public service corporations have in turn been routed into the channels of trade to purchase steel, cars, locomotives, lumber, paper and what-not.

Public Utilities and Salaried Men

The purchasing power of the public service and quasi-public service companies in normal times has been a chief reliance upon which general business and prosperity have rested.

But recent years have not been normal years. These companies have assumed a position not unlike that of the salaried man.

It is a homely but none the less a faithful analogy to compare, for instance, the railroad company to the salaried man. For let us picture the state of the man on a salary. Prior to the war his income was $10,000 per annum; his expenses were $6,000 per annum; and his annual savings, $4,000. His stock, it is supposed, was valued at $100 per share. Since the beginning of the war his expenses have mounted steadily, until finally they have reached beyond his income. His stock is now perhaps offered at $10 per share and few if any bids for it are to be found.

The salaried man must keep buying to keep going; whatever the price of clothing, shelter and food he must have them all. Each necessity of life which he buys—rubber, leather, woolen and cotton goods, labor, food and shelter; and each of his luxuries—gasoline, automobiles, jewelry, entertainments—each expresses the

name of some war-prosperity corporation or business enterprise.

So with the railroad and other public service companies. These must keep buying to keep going. As to locomotives, cars, lumber, labor, coal, oil and steel—those who have sold all these (to the railroads) necessities of life have lived in a paradise of prosperity.

War's Effect on Sellers and Buyers

The financial history of the "selling" companies from 1915 was marked by rising profits, high prices alike for their product and their securities, large dividends and great riches.

The history of the "buying" companies since 1915 has been marked by reduced profits, relatively low prices for their product, steadily declining prices for their securities, general uncertainty and in many instances actual or threatened ruin.

During the war new and powerful customers appeared as buyers of the products of the manufacturing and producing companies, the products which were necessities of their very life to the railroad and public service companies. Governments purchased billions of dollars worth from the "selling" companies and, in order to win a world war, the essence of the buying was speed in delivery of the goods required. Prices and wages mounted and gauged by all records during fifty years, the sky seemed to be the limit on prices and profits. Out of these conditions was born the misfor-

tune of the "buying" companies which were unable to pass on to the public by means of increased rates and fares the burden of steadily rising costs.

The investors in corporate securities were no longer relied upon to supply funds to keep the wheels of prosperity turning. At first foreign government and later United States Government bonds issued by the billions and the taxing power of nations supplied in ample sums the funds required to keep the orders flowing to the "selling" companies. Not only was the very issuance of so large amounts of Government bonds destined to injure the market price of corporation bonds generally, but the tax free covenants in the Government issues, combined with high super taxes on incomes, led to extensive selling on the part of investors not only of bonds but also of the stocks of corporations. Many individual investors who were formerly potential buyers in large blocks of corporation stocks and bonds were converted into sellers.

So we find that, quite apart from adverse political considerations, not one but several influences arising from conditions of war have been at work to depress those bonds and stocks which prior to the war were generally recognized, together with Government, State and Municipal bonds, as investment securities of the first order. Hundreds of such securities have been adversely affected marketwise, where at no time has there existed doubt as to their soundness.

We have referred to recognized fundamentals of permanent value found in certain railroad and public-service

bonds and stocks. Since early in the war these intrinsic fundamentals have served but feebly to protect investors for there has been no regularity of operation of normal influences, but quite the reverse, and these safeguarding factors have not had free play.

It is not surprising therefore to find so many who either have lost sight of or have come to consider of no importance these fundamentals of investment value.

As the factor of safety protecting their old line investments has diminished many have been led to exchange them for the securities of industrial companies, from which larger immediate income might be derived and where in the absence of strict Government or State regulation there appeared to be no limit to prices and profits.

So far this procedure has been advantageous; it remains to be proved by the event whether or not it will continue to be so. Many such exchanges of investments have been made where the railroad and public service stocks or bonds have been sold at prices averaging very low and other securities purchased at relatively high prices.

Return of Competition?

The war is past, although the conditions which have proved so injurious to thousands of investors have not yet abated. That they will abate leaves no room for doubt. The questions are "how soon," "in what manner," and "to what an extent."

Whether or not the waste of war is largely responsible for existing anomalous conditions; or unwise financial

policies of the Government; or inflation of credit or currency expansion or both, operating directly to decrease the purchasing power of the dollar; or lack of production; or decreased efficiency on the part of labor; or oppressive taxation; or repressive legislation; or public and private extravagance; or profiteering or waste or an altered psychological situation—whatever or how many the causes—whether or not due to all these causes inclusively, or to a few exclusively, or whether or not to this or that in whole or in part, the fact remains that present conditions are quite unusual and abnormal and are certain to change.

The surest remedy for existing ills will be found when more savings are directed to investment in Liberty bonds and in the securities of essential industries. It is a great day for the savers, inasmuch as their fifty-cent dollars invested today will one day grow to be seventy-five-cent or one-hundred-cent dollars.

We have been living in a sellers' market which will in time be turned into a buyers' market, to the undoubted benefit of the large "buying" corporations, the stocks and bonds of which are made the subject of our discussion. In order to safeguard the interests of national welfare a normal market must be restored; the abnormal conditions yet prevailing will in due course find their own corrective.

Correctives for Abnormal Conditions

With exchange against foreign countries, exports from this country will be restricted and the United States becomes the best market in the world in which to sell

foreign manufactured goods. It will at once appear, however, that it will be impossible to import into this country or in any other manner establish a transportation system to compete in its territory with the Pennsylvania Railroad or a telephone system to supplant the American Telephone & Telegraph Company. No more can the fundamental safeguards protecting choice real estate in New York City be altered by influences to which allusion is here made.

It has come to be freely and openly discussed whether or not the readjustment from the abnormal conditions referred to can be accomplished without a tormenting and excruciating commercial depression or financial panic. The outcome rests upon the knees of the gods, yet we find some measure of hope that no panic will result. In the very year of the beginning of the World War, following years of debate, a new Banking and Currency System was adopted designed to be sufficiently sound and elastic to avoid and prevent such "panics" as had theretofore been not infrequent by reason of the unscientific and archaic banking laws which had previously existed. No one of the creators of the new Federal Reserve System, we dare say, entertained any serious belief that the system could or would be successful in its operation, unless machinery was provided to insure not only orderly and controlled expansion and inflation but also orderly and controlled contraction and deflation. No more might it be expected of an automobile engine that it would prove successful in operation unless it gave power for an advance movement not only, but also for a reverse movement.

It is a matter of record that the banking machinery has successfully stood the test of expansion such as was not dreamed of when the System was put into operation in 1914; and by the same token may it not perhaps reasonably be expected so to control events incidental to contraction as to render impossible an actual panic?

There are uncertainties ahead, yet many of these concern themselves with inevitable changes which ultimately promise well for those stocks and bonds the market prices and in many cases the actual value of which have suffered during the war and post-war periods. With the return toward normal conditions the qualities of permanent value possessed by the securities of the so-called large "buying" companies and which are characteristic of them in normal times of peace, will find an opportunity to reassert themselves.

Transportation Act—Investor Recognized

It is a fortunate circumstance that the Transportation Act of 1920 gives promise of renewed confidence being imparted to railroad securities.

The Interstate Commerce Act was established with the avowed purpose to insure "reasonable" rates for transportation. The shippers were to be protected under supervision by government agencies. What with regulation by the States and by the Government, heavy taxation, mandatory orders to raise and depress tracks, to provide safety appliances; these, with full crew bills, demands by labor for higher wages and shorter hours,

and either reduction of rates or refusal adequately to increase rates by the Interstate Commerce Commission—all combined so to restrict profits, to narrow the Margin of Safety in earnings for the protection of the financial integrity of many companies, and to surround the entire railroad "problem" with such uncertainty that their securities have steadily lost favor among investors. Then superimposed upon all have come the added burdens arising from the war.

In recent years, but especially during the period of Government operation of the railroads, the public's conception of the relation of labor to railroad operation has apparently altered. Before the entry of the United States into the war demands for increased wages were allowed by the Government, despite protests on the part of the railroad managers. During the war further large increases were put into effect so that the Government it appears then came to assume toward labor as previously it had assumed toward shippers the role of guardian, to the end that their just expectations as to wages on the one hand and rates on the other hand might be realized.

Where has the investor stood? Quite alone and unprotected. What with the demands of shippers and those of labor, coupled with the unfriendly if not quite hostile propaganda of both groups, not to mention that of politicians themselves, the position of the investor has indeed been a sorry one. Furthermore his security neither of mind nor of pocket has been enhanced by the financial exploitation to which certain companies have been subjected, not to speak of the grossly misleading

statements too frequently issued by or under the authority of the Interstate Commerce Commission.

As a natural sequence to the events of recent years the well-springs supplying fresh capital have been drying up and the building of new lines has practically ceased. Thus new legislation became imperative and the Transportation Act of 1920 was passed by both houses of Congress by an overwhelming majority.

This Transportation Act marks a decided change in legislative policy as applied to the transportation industry. The Act introduces a new principle in Government regulation of the carriers and reflects a changed public attitude as regards supervision of all public service companies. The promise of better conditions to result from this change to holders of securities of such companies cannot too strongly be emphasized.

Under the Transportation Act, the Interstate Commerce Commission is not only invested with the authority but is expressly directed to protect and assist the railroads. Heretofore, the Commission's chief function was considered to be that of "protecting" the public. The record of the decline and fall of railroad securities during the past fifteen years would appear to indicate that regulatory bodies have considered that protection of the public might not be adequately secured without favoritism to the shippers and injury to the carriers and investors in their securities.

No extended discussion will be attempted here as regards the minute details of the Transportation Act itself. In a word, the recent legislation establishes the new

principle that merely because the carriers are called quasi-public corporations and the servants of the public, are engaged in the business of furnishing a necessity of life, in a business which has been declared to be "affected with a public interest," they shall not be deprived of the privilege of passing on to the consumer through increased rates the burden of higher costs. This procedure has been considered just and reasonable and its benefits allowed to producers, merchants and manufacturers, to bankers and brokers, lawyers and doctors, to Government, States and Municipalities alike—to all save only those who have been so unfortunate as to have engaged their resources in the business of supplying to the public, transportation, gas, electricity, transit facilities and such other necessary quasi-public services.

Security Prices vs. Property Investment

Railroad securities are selling in the market at a valuation which will likely be demonstrated by the event to be much below their actual value. That there is abundant warrant for this assertion is clearly indicated:

(1) By the tentative valuation figures already compiled by the Interstate Commerce Commission.

(2) By the testimony submitted by the carriers in support of the integrity of their property investment accounts and

(3) By the corroborating evidence found in the record of the large sums expended on the properties and derived not only from cash proceeds of hundreds of millions of dollars of bonds and stocks originally sold at prices far above current quoted prices, but also from surplus earnings.

A few illustrations will serve to elucidate this point.

(1) The preliminary reports on valuation of the Boston & Maine R. R. Co. and the New York, New Haven & Hartford R. R. Co., the securities of which are quoted at a large discount, indicate that, based upon prices taken at or prior to 1914, the cost of reproduction of the new properties and present value of lands owned, largely exceeds the investment in road and equipment as shown on the carriers' books, as of date of valuation.

(2) Pennsylvania Railroad Co.'s stock is valued in the market at approximately $400,000,000 or at least $150,000,000 less than the amount of cash received by the company against which the stock was issued. The following remarks are taken from an address delivered in April, 1919 by the President of the Pennsylvania Railroad:
"I would point out that in many of our strongest companies, and notably in the case of The Pennsylvania Railroad System, which consists of weak lines as well as strong lines, part of the surplus was continuously put back into betterments and improvements, and aiding traffic-feeding lines, as a conservative measure of finance. The surplus of the Pennsylvania System did not arise from extortionate rates, but very largely from paying dividends to stockholders below the prevailing return in other companies for a series of years, and also from profits on long time investments, and through premiums on some of its capital stock issues. To be conservative and lay a foundation for continued growth, the stockholders were willing to relinquish a portion of the profits over a term of years and in this way the Pennsylvania System in seventy-two years invested in its railroad property for public use about $430,000,000 in excess of its capital issues held by the public. This undercapitalization explains why the Parent Company has been able to continue its 6% dividends despite such low returns on the property investment."

(3) The Chicago & North Western Ry. Co. has outstanding

about $145,000,000 common capital stock, of which $110,000,000 has been issued since 1900 for $110,000,000 cash paid in; that is at $100 per share. Undivided profits since 1900 have amounted to $72,000,000 during the past decade.

(4) According to official statements issued by the Erie R. R. Co. it appears that during nineteen years to January 1, 1920, this company had expended in improving its physical property in excess of $140,000,000, of which amount approximately $73,000,000 was derived from income. Furthermore, over $11,000,000 has been applied from earnings for Sinking Funds.

The real significance of these figures is disclosed when comparison made with the present market value of the bonds and stock which comprise a large majority of the securities issued by the Company shows such value to be below the $84,000,000 applied from earnings for improvements and Sinking Fund payments.

	Issued	Market Price	Market Value
Prior Lien Bonds	$35,000,000	50	$17,500,000
General Lien Bonds	*55,104,000	40	22,041,600
Convertible Bonds	§50,000,000	35	17,500,000
First Preferred Stock	47,904,000	20	9,580,880
Second Preferred Stock	16,000,000	14	2,240,000
Common Stock	112,481,900	12	13,497,828
	$316,490,300		$82,360,308

*Of which owned by Company (practically all pledged), $19,219,000.
§Of which owned by Company (practically all pledged), 9,357,900.

Furthermore, substantial cash sums were derived from the sale in recent years of certain of the above mentioned issues. For example, the Company realized from the sale of the $40,642,100 Convertible Bonds alone (dated 1903) the sum of $35,898,035; of this issue $8,372,000 bonds are pledged as part collateral for

$15,000,000 short term notes which were originally sold at about their face value for cash.

Illustrations such as those cited above in respect of "poor" and "rich" companies alike might readily be extended to embrace scores of railroads and public utility companies and would give every indication that the physical values of their properties far exceed the market value of their securities.

Sound Value

One has heard much in recent months of the "sound value" found to exist in respect of physical properties of many industrial companies. As applied to buildings and plants "sound value" means reproduction cost today less accrued depreciation and as applied to real estate, its present value. The point cannot be emphasized too strongly that railroad securities at their existing low level of prices are abundantly protected if the measure of protection is taken to be "sound value."

When speaking of "sound value," let us refer to a specific stock in order to bring out more positively our demonstration. The Chicago & North Western Ry. Co.'s preferred stock is outstanding to the amount of $22,395,120. This stock is entitled to non-cumulative dividends of 7% per annum; after the common stock shall have received in any year 7%, the preferred is entitled to 3% additional; and after the common stock shall have received 10% in any year, both issues share alike in any further division of profits for the year. Since 1878 regular dividends have been paid annually upon this

preferred stock. The rate has not been under 7% per annum; at times a higher rate was paid, including the period from July, 1902 to January, 1920 inclusive, when the annual rate was 8%. On June 9, 1920, the dividend was reduced to 7% per annum.

We have but now stated that since 1900 the undivided balance of income reported by the Chicago & North Western Ry. has amounted to over $72,000,000 and $110,000,000 common stock has been sold by the Company at par value for cash. Thus during the past decade over $182,000,000 cash has been turned into the property in one way or another, this sum derived either from surplus earnings or from the sale of stock ranking junior to the $22,395,120 preferred stock.

These facts should demonstrate conclusively that the preferred stock of the Chicago & North Western Ry. is amply protected by "sound value," yet transactions in this stock have recently been made in the market at $100 per share and under, the lowest prices recorded in upwards of forty years.

In the field of the securities—bonds and stocks alike—of the large "buying" companies, illustration following illustration may be cited where identical facts are disclosed, yet it is found that securities of this nature have been out of fashion as it were for some time past. The investment banker might well say of those of his clients who in recent years have evinced eagerness to place their funds in railroad securities that their "footsteps in the street became so rare that he could hear them coming, count them as they passed, and lose them in the hollow distance."

Earning Power

Of a certainty, sound value without net earning capacity is of little avail for protection of security holders and it is especially in this respect that the position of the railroads has been so insecure. State and Federal regulatory authorities acting independently, and frequently in conflict have regulated without recognized responsibility for net income results or requisite margin of safety for credit preservation. Expenses for years have been advancing while rates on the whole were regulated downward or held unchanged and all the while the purchasing power of the dollars represented in a declining net income was steadily being reduced.

Under the new Transportation Act aggregate property value is recognized to be entitled to its just compensation and rates are to be established to afford net earnings equivalent to a fair return upon such value. The Act reads:

> "The Commission shall from time to time determine and make public what percentage of such aggregate property value constitutes a fair return thereon, and such percentage shall be uniform for all rate groups or territories which may be designated by the Commission. In making such determination it shall give due consideration, among other things, to the transportation needs of the country and the necessity (under honest, efficient and economical management of existing transportation facilities) of enlarging such facilities in order to provide the people of the United States with adequate transportation."

Provision is made that during two years beginning March 1, 1920, a fair return shall be equal to an average

of *5½% (or as nearly as may be) of aggregate value of all carriers, with discretion resting with the Commission to make the sum equal to 6% of aggregate value. Earnings of any company in excess of the statutory "fair return" and in excess of 6% upon the value of its property are to be equally divided between the Government and the company according to prescribed terms; such sums, however, are to be applied (1) by the company to a reserve fund, at first, and beyond a stated amount to general corporate uses and (2) by the United States to a special fund to be used "in furtherance of the public interest in railway transportation."

It is interesting to call to mind that scores of millions of dollars have been expended and charged to capital account by railroads for additions and betterments, from which outlays by the very nature of things no adequately compensating return could be derived. This is especially true of many companies operating in densely populated sections. We refer to expenditures such as those for raising and depressing tracks through cities, etc. Thus a large aggregate of physical value will, it is likely, be indirectly brought to larger productive use than heretofore in that this value will become recognized as a basis for rate-making.

The Transportation Act of 1920 provides that rates shall be adjusted so that the net operating revenues of carriers as a whole "under honest, efficient and economical management" shall approximate as nearly as may be a prescribed amount. In the light of the record of injury inflicted upon innocent investors by financial

*Thereafter a rate of 5¾% was designated.—J. H. O. & Co., 1926.

exploitation to which certain railroads have been subjected, reference may not be omitted here to the protections afforded to investors by the Transportation Act beyond those previously discussed. The Act prescribes certain regulations designed to benefit investors and proscribes as well certain practices heretofore employed which have worked incalculable harm to thousands of investors.

Speculative Opportunities Restored?

There was a time a few years since when the interest of investors and speculators was centered largely upon the securities of railroads and utilities as promising most lucrative rewards. In that day all kinds of securities were created, and purchased by investors whose inclination was stimulated by various ingenious arguments and contrivances. There were issued and sold at high prices debenture bonds, participating bonds, guaranteed, collateral trust and convertible bonds, both long- and short-term bonds; and voting and non-voting stock, stock trust certificates, and what-not; and let it be understood that not the companies, but rather, as the event has shown, the investors were the losers. Arguments about the "fundamentals" of value were openly declared and many a latterly prosperous "industrial" was represented as a good example of what a genuine investment security should not be.

Be this as it might, it is well to recall the record of the past in order the better perhaps to project our minds into the future. During the unusual war and post-war period as many ingenious doubts have been thrown in

the way of any disposition on the part of investors in favor of the so-called old-line investments (at prices far below those ruling in the earlier days) as there were formerly ingenious arguments and devices offered to attract their attention to them.

So we have found a prevalent opinion that neither speculation nor profits need ever again be expected to be associated with securities of public utilities and of railroad companies.

Whoever has accompanied us thus far in this discussion will perhaps agree that such will not be the case, having in mind all the time that railroad securities are selling at no inflated prices, but quite the reverse.

Our opinion is that at this time many bonds of railroad and public utility companies, not to mention their stocks, offer the surest and most promising speculative opportunities to be found in the entire market.

The Transportation Act permits consolidation and mergers of carriers after submission to and approval by the Interstate Commerce Commission according to prescribed limitations. Who will believe, taking all matters into consideration, that railroad securities will in the future be free from speculative operations?

Have not signs of a coming era already appeared?

On February 11, 1920 the stock (present dividend rate 4%) of the Pittsburgh, Cincinnati, Chicago & St. Louis Ry. sold at 50. On March 10, 1920 the stock sold at 66; on that date announcement was made that 5% bonds (guaranteed by the Pennsylvania R. R.) would be offered in exchange, dollar for dollar, for the

stock; and the stock advanced to above 80. Of approximately $85,000,000 stock outstanding about $66,000,000 stock was owned by the Pennsylvania R. R. On recorded transactions involving only about 11,000 shares this stock advanced from February 11, 1920 to March 11, 1920 inclusive over $30 per share, representing a total appreciation in market value of over $25,000,000.*

When more normal conditions are restored, that is to say, when there shall be less competition by buyers to buy and more competition by sellers to sell, then the railroads and utilities will undeniably be headed for better conditions. Considerably in advance of the fact itself the prices of their securities will have begun to anticipate the promised benefits.

Fair Profits Indicated

We are not to be understood as assuming in respect of the future for our leading industrials an altogether pessimistic attitude. Most of these companies have inherited from war conditions huge profits and great riches; the stockholders of many have already received more than handsome dividends and rewards; and some of the companies, it will be remembered, have inherited not only large earnings and riches but also an assured continuing earning capacity far greater than might otherwise have been achieved in a long period of years. For the products of certain companies, and in some instances their highly specialized products, have been

*Railroad share market in years since 1920 has been accompanied by numerous proposals of merger and actual purchases of stock interest by certain roads in others; in all cases the effect has been favorable to market values.—J. H. O. & Co. 1926.

successfully introduced into consumption to an extent which might not have been accomplished in times of peace at millions of dollars cost of advertising.

Yet on the whole, the period, which for the industrials has been marked by enormous profits, more or less unrestricted prices, no less than by restricted competition or absence thereof, is passing. The profits arising from contracts based upon low cost inventories will in many instances be followed by corresponding losses. In some instances the high scale of wages permitted by unusually generous profits will perhaps be capable of reduction only following a showing of comparatively poor profits, if not substantial losses.

Furthermore, it appears that railroad rates are at last to be adjusted to counterbalance the disproportion which has for so long existed between expenses and income; individuals and industrials will, it is expected, no longer profit unduly, either directly or indirectly, at the expense of the transportation companies.

Under the provisions of the Transportation Act of 1920 the public will be called upon to pay fares and rates which shall be adequate to support the transportation machine with due provision for the rights and interests of shippers, employees and investors. The public may now be expected to keep a wary eye upon the uses to which the funds involved are surrendered. Unjustified diversion of the carriers' resources will likely not be tolerated longer.

Financial interests may not operate with a free hand. There will be regulation of the issuance of securities and other provisions are stipulated in the Act to protect the carriers.

Rates will be regarded as matter-of-fact payment for services rendered and not as in any sense available for benefits to favored shippers.

The reception accorded the "Plumb Plan" has more than incidental significance as indicating what the public's attitude will be towards bodies of employees when in their demands they go beyond what the "great third party in interest" believes is fair.

Trend Towards Regulation of Industrials?

This brings us to a final suggestion in respect of certain "selling" companies. Does the trend of legislation and public opinion lead us to the conclusion that the suppliers of railroad supplies, the sellers of rails, rolling stock, etc., will continue exempt from regulations, to charge what they can; or will the same searching question which financial interests, shippers and labor must satisfy, likewise be applied to them—What is reasonable?

All processes of socialization such as have marked the history of our country's progress have in their time and place been novel. Many privately owned, privately managed and supposedly private enterprises have had to yield their particular interests to the service of the public welfare. Privately owned banks and trust companies, insurance companies, companies supplying

the public with water, gas and electricity and local and interstate telephones, telegraph and transportation facilities—all have journeyed along the same path toward the same goal. The path, although at times much travelled, has always been obstructed with many difficulties, such as regulation, supervision, prescribed methods of accounting, establishment of depreciation and reserve funds, mandatory orders, questions arising as to what constituted a fair percentage of profit and, after all, what values should be allowed upon which such fair rate of profit should be reckoned.

Who has the temerity to say in this day and age that certain industrial companies, producing and manufacturing necessities of life, will succeed in averting the trials to which our railroads and "public" enterprises have been subjected? We believe that many will have to pass successfully tests of "fairness," now only in the process of being evolved. What these tests of "fairness" have meant to the holders of securities of railroad and public utility companies has already been disclosed.

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